Supreme Court, U.S.
FILED
FEB 5 1996
CLERK

(3)

No. 95-984

IN THE
Supreme Court of the United States
OCTOBER TERM, 1995

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY,

Petitioner,

v.

STATE OF NEW JERSEY, COMMISSIONER OF INSURANCE, *et al.*,

Respondents.

On Petition for Writ of Certiorari to the Superior Court of New Jersey, Appellate Division

BRIEF *AMICI CURIAE* OF THE AMERICAN INSURANCE ASSOCIATION AND THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS IN SUPPORT OF PETITIONER

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16 pp

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	ii
INTEREST OF *AMICI CURIAE*	1
SUMMARY OF ARGUMENT	2
ARGUMENT	3
A. Substitution of an Average-Rate-of-Return Rule for the Constitutionally Mandated Cost-of-Capital Standard Virtually Guarantees Confiscation	4
1. Loss of the Opportunity to Recover Cost of Capital Undermines the Financial Stability of Insurance Companies and the Security That Policyholders Purchase	4
2. The New Jersey Court's Average-Rate-of-Return Rule Bears No Relation to the Constitutionally Mandated Fair Rate of Return and Will Create a Downward Spiral Toward Greater Confiscation	7
B. In Justifying Its New Rule by the Retroactive Nature of the Proceedings Below, the New Jersey Court Has Supplied a Road Map for Confiscation	9
CONCLUSION	12

TABLE OF AUTHORITIES

	Page(s)
Cases:	
Calfarm Ins. Co. v. Deukmejian, 48 Cal.3d 805, 771 P.2d 1247 (1989)	10
Dolan v. City of Tigard, 114 S. Ct. 2309 (1992)	3
Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989)	3
Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)	5,11
First English Evangelical Lutheran Church v. County of Los Angeles, 482 U.S. 304 (1987).	3,11
Guaranty Nat'l Ins. Co. v. Gates, 916 F.2d 508 (9th Cir. 1990)	10
Jersey Cent. Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987)	5
Lucas v. South Carolina, 112 S. Ct. 2886 (1992)	3
Nationwide Mut. Life Ins. Co. v. Foster, 739 F. Supp. 962 (M.D.Pa. 1990)	10
Nollan v. California Coastal Comm'n, 483 U.S. 825 (1987)	3
Southwestern Bell Tel. Co v. Public Serv. Comm'n, 262 U.S. 276 (1923)	5

State Farm Mut. Auto. Ins. Co. v. State of New Jersey, 590 A.2d 191 (N.J. 1991)..... 10,11

20th Century Ins. Co. v. Garamendi, 8 Cal.4th 216, 878 P.2d 566 (1994), *cert. dismissed*, 115 S. Ct. 1085, *cert. denied*, 115 S. Ct. 1106 (1995)..... 4,10,12

United States v. Salerno, 481 U.S. 739 (1987) 10

Statutes:

Cal. Ins. Code § 1861.01 (West 1996)..... 10

Haw. Rev. Stat. § 431.10C-202.5 (1995) 10

1989 Nev. Stat. ch. 784 10

N.J. Stat. Ann. 17.33B-1 *et seq.* (West 1996) 9

75 Pa. Cons. Stat. Ann. § 1799.7 (1995)..... 10

Tex. Ins. Code Ann. art. 5.131 (West 1996)..... 10

Other Authorities:

Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 13 (4th ed. 1991)..... 5

National Association of Insurance Commissioners, *Report on Profitability by Line by State in 1994* (October 1995) 8

INTEREST OF *AMICI CURIAE**

The American Insurance Association "AIA" is a national trade association, with headquarters in Washington, D.C., representing more than 270 property and casualty insurance companies in the United States. In 1994, AIA member companies wrote $52.7 billion in insurance premiums, $3.2 billion in New Jersey.

The National Association of Independent Insurers ("NAII") is a national trade association, with headquarters in Des Plaines, Illinois, representing more than 570 property and casualty insurance companies in the United States. In 1994, NAII member companies wrote $65.9 billion in insurance premiums, $1.68 billion in New Jersey.

Many AIA and NAII member companies are subject to New Jersey automobile insurance rate regulation. AIA member companies provided 21.7 percent of private passenger automobile insurance coverage in New Jersey in 1994. NAII members companies provided 22 percent of automobile insurance coverage in New Jersey that year.

AIA and NAII member companies also sell insurance in every other state in the Union, all of which regulate insurance rates. AIA and NAII file this brief *amici curiae* because of their interest in preventing New Jersey and other states from taking the property of member companies through confiscatory insurance rate regulation. *Amici* legitimately are concerned that, as New Jersey has joined California in adopting an erroneous constitutional standard, other states may join in a race to the bottom that will threaten the survival of insurance companies.

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*Counsel to the parties have consented to the filing of this brief. Letters of consent have been filed with the Clerk.

SUMMARY OF ARGUMENT

This is a case of great and potentially destructive import. The New Jersey court has provided both a rule that allows states to drive down insurance rates with almost no constitutional check, and the procedural mechanism through which to achieve that result.

The New Jersey court discarded the cost-of-capital standard in the constitutional analysis of rate regulation in favor of a rule that looks only to the national average rate of return. The opportunity to recover cost of capital is a necessary element of a constitutionally adequate regulated rate. The cost of capital describes the rate of return a business must produce to attract capital in a competitive market. If a business is not expected to produce a rate of return at least comparable to that available from other investments, capital will flow away from the business into superior investments. An insurance company that cannot recover its cost of capital will begin a cycle of lost capital that will increase the riskiness of the firm and threaten its financial integrity. This decline in capital imposes heavy costs on policyholders because the insurance company's ability to handle future losses is diminished.

The New Jersey court's substitute for cost of capital, the national average rate of return for automobile insurance, is constitutionally deficient. The nationwide average rate of return ignores all of the local variables that determine a firm's protected property interest. At the same time, the national average is too narrowly focused to account for the extreme volatility in the automobile insurance market. Worst of all, the national average reflects regulated rate reductions in other states. The New Jersey court's average-rate-of-return rule will allow states to confiscate as long as other states are doing the same.

The New Jersey court purported to limit application of its new takings rule to retroactive review, in which the takings determination is made after the challenged rate has been in effect. This supposed limitation may actually compound the problem. Retroactive relief is often critical to the maintenance of minimal constitutional protections

from confiscatory insurance reform legislation; the possibility of retroactive relief is a linchpin of several state regulatory schemes. The New Jersey rule grants confiscatory authority to each such state, and is sure to motivate similar practices throughout the Nation. Moreover, retroactive relief will be mandated in numerous cases in which an as applied takings challenge is resolved after the effective date of the challenged rate. By tying its new rule to retroactive proceedings, the New Jersey court has provided a road map for confiscation.

ARGUMENT

In a series of recent cases, this Court has reaffirmed the strong constitutional protection against the taking of private property without just compensation. E.g., *First English Evangelical Lutheran Church v. County of Los Angeles*, 482 U.S. 304 (1987); *Nollan v. California Coastal Comm'n*, 483 U.S. 825 (1987); *Lucas v. South Carolina*, 112 S. Ct. 2886 (1992), *Dolan v. City of Tigard*, 114 S. Ct. 2309, 2320 (1994) ("We see no reason why the Takings Clause of the Fifth Amendment, as much a part of the Bill of Rights as the First Amendment or Fourth Amendment, should be relegated to the status of a poor relation . . . ."). Those cases involved real property rights. No less important, and equally entitled to the protections of the Fifth Amendment, is the property right of a regulated business to earn a fair and adequate rate of return. See, e.g., *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989). The New Jersey court in this case ignored this right through the establishment of a takings rule certain to eviscerate any constitutional check on rate regulation. Review and reversal in this case will allow this Court to reestablish Fifth Amendment rights and clarify the constitutional takings standard in rate regulation.

The New Jersey court held that the constitutional review of a regulated rate need not consider the regulated firm's cost of capital, even though recovery of cost of capital is critical to the long-term survival of any business. Rather, the court held, it is sufficient to determine

confiscation by looking to an arbitrarily-selected nationwide average rate of return. The New Jersey court's new standard applies whenever the constitutional review takes place in a retrospective proceeding, that is, whenever the regulated firm already has suffered loss of revenue from the regulation. This decision is an invitation to confiscatory ratemaking nationwide.

A. Substitution of an Average-Rate-of-Return Rule for the Constitutionally Mandated Cost-of-Capital Standard Virtually Guarantees Confiscation

With the present decision, New Jersey--long a leader in insurance regulation--joins California, another bellwether state, in discarding the cost-of-capital standard in the constitutional review of ratemaking. The New Jersey court in this case expressly relied on *20th Century Ins. Co. v. Garamendi*, 8 Cal.4th 216, 878 P.2d 566 (1994), *cert. dismissed*, 115 S. Ct. 1085, *cert. denied*, 115 S. Ct. 1106 (1995), where the California Supreme Court held that the opportunity to recover cost of capital is not a necessary element of a constitutionally adequate insurance rate. These leading decisions form a dangerous and unconstitutional trend.

1. Loss of the Opportunity to Recover Cost of Capital Undermines the Financial Stability of Insurance Companies and the Security That Policyholders Purchase

The effect of a state-regulated rate that precludes a company from recovering its cost of capital is more than just a cost of doing business in a regulated environment. Such regulation goes beyond a diminution in profits; recovery of the cost of capital is necessary to the continuing viability of any business. For this reason, a regulated rate that guarantees that a business will not be able to recover its cost of capital is a taking:

> The compensation which the Constitution guarantees an opportunity to earn is the

> reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital.

Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 291 (1923) (Brandeis, J. concurring). Accord *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944).

The opportunity to recover cost of capital is part of the Fifth Amendment's minimum constitutional guarantee to any regulated firm. A state cannot prevent a legitimate enterprise from attempting to stay in business; without the opportunity to recover its cost of capital, no business can do so. A regulated rate that prevents a firm from recovering cost of capital is a taking, however, long before the firm is driven to bankruptcy. A firm that cannot recover its cost of capital, by that fact alone, suffers "the sort of deep financial hardship described in *Hope." Jersey Cent. Power & Light Co. v. FERC,* 810 F.2d 1168, 1181 n.3 (D.C. Cir. 1987) *(en banc).*

An insurance company, like any other business, is an investment. Those who supply capital to the firm do so with the expectation that they will receive a return on their investment. There is a market for such capital. The decision to invest capital in any particular business will be based on the expected rate of return and the risk involved.

The cost of capital describes the rate of return a business must produce to attract capital in a competitive market: The cost of capital, sometimes called the "opportunity cost of capital," is the expected rate of return available from other investments with comparable risk. Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 13 (4th ed. 1991). See also *Hope,* 320 U.S. at 603 ("the return to the equity owner should be commensurate with returns on investments in other

enterprises having corresponding risks"). It is an opportunity cost because the cost of capital is the opportunity foregone by investing in one investment rather than another. If a business is not expected to produce a rate of return at least comparable to that available from other investments with similar risk, capital will flow away from that business into superior investments.

It is not enough that a business make a profit; the rate of return must be sufficiently high to warrant the risk that capital investors face or they will put their money elsewhere. The riskier the business, the higher the rate of return the business must produce to attract capital.

Insurance is by definition a risky business; future uncertain events are an insurance company's stock in trade. Insurance companies must make a profit comparable to other risky investments. The New Jersey Court concluded that State Farm's low 3.4 percent rate of return in 1990--which the court acknowledged was the product of the state-imposed surtaxes and assessments--was within the range of constitutional fairness. Pet. App. 25a, 26a, 31a. But a rate of return limited by government regulation to 3.4 percent is plainly insufficient in a market (in 1990) where investors could earn more than twice that much by investing in risk-free government securities. An insurance investor faces the significant risk of losing capital to future unforeseen events against which the company has insured, and must be compensated accordingly. The cost of capital takes into account the riskiness of the business. The regulatory scheme New Jersey court approved ignores risk and ignores the certainty that investors will move capital into safer investments or into investments of comparable risk with a higher rate of return.

An insurance company's primary capital is the funds that stand behind its ability to pay claims and meet the demands of unexpected events. When catastrophes occur, claims must be paid from this surplus. The insurance company must replace that capital if it is to continue to operate and support its policyholders. But if a state has mandated that a company cannot charge rates sufficient to

cover the cost of capital, new capital may not be forthcoming.

Even in the absence of unforeseen disasters, a company unable to recover its cost of capital eventually will find its capital going elsewhere. Mutual companies like State Farm, which pay out profits in the form of dividends to policyholders, will lose policies. Stock companies that cannot cover their cost of capital will see the value of their stock drop, making it far more difficult to raise capital through loans and the issuance of new securities. A company guaranteed not to make its cost of capital will begin a cycle of lost capital that will significantly impair the firm.

The decline in capital that results from a confiscatory regulated rate imposes heavy costs on policyholders as well as on the owners of insurance companies (in the case of mutual companies, they are the same). When an insurance company loses its surplus capital, its ability to handle future losses is diminished. The enterprise becomes riskier for policyholders, both in New Jersey and in every other state in which the company writes policies. In the insurance industry, this is fatal risk, for the stability of the firm and its ability to stand behind its policies is the protection that policyholders purchase. What is taken in such a case is not only the property of the insurance company, but the security of policyholders.

2. The New Jersey Court's Average-Rate-of-Return Rule Bears No Relation to the Constitutionally Mandated Fair Rate of Return and Will Create a Downward Spiral Toward Greater Confiscation

As the prior discussion demonstrates, the cost of capital measures in economically meaningful terms a firm's ratemaking property interest. The New Jersey court discarded this standard, concluding without any asserted justification that the nationwide annual average rate of return for private passenger automobile insurance

establishes a reasonable rate for constitutional purposes. The New Jersey court's standard is woefully inadequate.

An as-applied takings analysis must adequately incorporate the myriad factors that affect property values. Yet the New Jersey court here concluded that it could assess confiscation of a particular company's business in New Jersey by looking at the average property of all insurance companies nationwide. It is as if the New Jersey court held that adequate compensation for condemnation of a home in an upscale New Jersey suburb is the average price of homes nationwide. Such a blunderbuss approach will capture the particular property interest at stake only by sheer luck.

The nationwide average rate of return ignores all of the local variables that determine a firm's protected property interest. A national average does not reflect, for example, the dramatic differences in automobile insurance environments across the country. Between-state differences in weather conditions, quality of roads, speed limits, traffic law enforcement, age of drivers, and regulatory environment all can and do affect automobile insurance rates of return. These variables will be reflected in an insurance company's cost of capital, but are washed away in a national average.

While the national average rate of return is too crude an instrument for proper takings analysis, it is also too narrowly focused to account for the extreme volatility in the automobile insurance market. A one-year average is a snapshot; it does not reflect the rapid fluctuations in the conditions for insurance that occur over time. For example, the national average rate of return on net worth for private passenger automobile insurance between 1985 and 1994 varied from a low of 4.5 percent in 1985 to 14.3 percent in 1992. National Association of Insurance Commissioners, *Report on Profitability by Line by State in 1994* § 4, p.8 (October 1995). A low average in any one year could well reflect a particular event, like the recent Blizzard of '96, that produces large liabilities for insurance companies in particular states and pushes the national average rate of return well below the cost of capital. A regulated rate tied to the national average that forces an

insurance company in essence to absorb liabilities to which it was not actually subject, is a taking.

Perhaps the most pernicious aspect of the New Jersey court's average-rate-of-return rule is that it makes no allowance for the fact that every state in the Union regulates automobile insurance. The national average rate of return therefore reflects regulated rate reductions in other states. Each of these regulated rates is, of course, itself subject to constitutional attack. Yet the New Jersey court has ruled that a state may prevail against such an attack if it regulates insurance rates, and therefore insurance company rates of return, down to the same level as other states: "The 'takings' clause requires no remedy where the effect of price regulation has been to reduce actual return to the industry average." Pet. App. 23a. In other words, confiscation is allowed as long as everyone else is doing it. Such reasoning, if adopted in other states, poses the real danger of driving regulated insurance rates well below the level of confiscation with no constitutional check.

B. In Justifying Its New Rule by the Retroactive Nature of the Proceedings Below, the New Jersey Court Has Supplied a Road Map for Confiscation

The New Jersey court purported to limit application of its new takings rule to cases in which the takings determination is made after the challenged rate has been used. This limitation in no way diminishes the importance of this case. To the contrary, the possibility of retroactive relief is a linchpin of several state regulatory schemes; it is the very feature that protects these regulatory statutes from facial invalidity. The confiscatory authority the New Jersey rule gives to these states will motivate similar practices throughout the Nation. Moreover, retroactive relief will be mandated in numerous cases in which an as-applied takings challenge is resolved after the effective date of the challenged rate.

The New Jersey Fair Automobile Reform Act, N.J. Stat. Ann. 17:33B-1 *et seq.* (West 1996), which underlies petitioner's takings challenge in the present case, is one of

several insurance reform statutes enacted by various states in recent years. See, e.g., Cal. Ins. Code § 1861.01 (West 1996); Haw. Rev. Stat. § 431:10C-202.5 (1995); 1989 Nev. Stat. ch. 784, *invalidated*, *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990); 75 Pa. Cons. Stat. Ann. § 1799.7 (1995); Tex. Ins. Code Ann. art. 5.131 (West 1996). All of this reform has attempted to force a reduction in insurance rates, generally through mandated rollbacks. The New Jersey Act also attempts to maintain low insurance rates for high-risk drivers through unrecoverable surtaxes and assessments against insurance companies. Not surprisingly, these blunt instruments have brought takings challenges from the affected insurers. See, e.g., *Calfarm Ins. Co. v. Deukmejian*, 48 Cal.3d 805, 771 P.2d 1247 (1989); *State Farm Mut. Auto. Ins. Co. v. State of New Jersey*, 590 A.2d 191 (N.J. 1991); *Guaranty Nat'l*, 916 F.2d 508; *Nationwide Mut. Life Ins. Co. v. Foster*, 739 F. Supp. 962 (M.D.Pa. 1990).

Facial challenges are "the most difficult challenges to mount successfully, since the challenger must establish that no set of circumstances exists under which the [statute] would be valid." *United States v. Salerno*, 481 U.S. 739, 745 (1987). Facial takings challenges to insurance reform legislation, accordingly, have tended to fail, with courts holding that the statute or regulations at issue allow an individual insurer to obtain relief from confiscatory rates in a later as-applied challenge. The purported relief often is to be determined retroactively. Thus, a federal district court noted that the Pennsylvania statute provided a "constitutional safety valve" by which the Insurance Commissioner could provide "retroactive relief in the future if rates resulting from [the insurance reform statute] are insufficient." *Nationwide*, 739 F. Supp. at 964. The California Supreme Court struck a portion of California's insurance rollback legislation, but allowed the rollbacks to go forward with assurances that insurers would be protected from confiscatory rates. *Calfarm*, 48 Cal.3d at 822. The ensuing retroactive rate hearings resulted in the California Supreme Court's rule that cost of capital is not a necessary element of takings review in a retroactive proceeding. *20th Century*, 8 Cal.4th at 292-97.

The present case is, of course, another example: The New Jersey Supreme Court in 1991 rejected State Farm's claim that the new surtaxes and assessments would produce confiscation, dispatching State Farm to the retroactive proceedings from which it now seeks review. *State Farm*, 590 A.2d at 207. When State Farm demonstrated in those proceedings that the surtaxes and assessments produced precisely the effect State Farm had predicted, the Insurance Commissioner and appellate court changed the rules.

Retroactive relief is critical to the maintenance of minimal constitutional protections from confiscatory insurance reform legislation. If a court or administrator refuses to grant up-front relief in a takings challenge, the regulated firm must be assured of the protections of the *Hope* cost-of-capital standard when constitutional review eventually takes place. The New Jersey Supreme Court in 1991 relied heavily on the cost-of-capital standard in defense of the theoretical protections offered by the New Jersey insurance reform statute. *State Farm*, 590 A.2d at 199, 206. The New Jersey appellate court then discarded that standard in practice, effectively eliminating meaningful constitutional review. Review by this Court is necessary to maintain the constitutional standard in retroactive cases.

The prevalence of retroactive takings review extends beyond challenges to insurance reform legislation. In any case in which an insurance commissioner rejects an insurer's filed rate in favor of a lower rate, the insurer may have a takings challenge. If, as is the case in some states, the insurer is forced to use the rate approved by the commissioner, or an interim rate, during the pendency of the takings challenge, the reviewing agency or court will be faced with a retroactive determination. If the decision maker determines that the insurer is entitled to a higher non-confiscatory rate going forward, the insurer also will be entitled to relief for the period of the "temporary taking" while the approved or interim rate was in effect. See *First English*, 482 U.S. 304 ("temporary" taking later found unconstitutional requires compensation). The "retroactive takings analyses" of the New Jersey court in the decision

below, and of the California court in *20th Century*, will be applicable in each such case.

The teaching of this case and of the *20th Century* decision is that a state may implement draconian insurance reform, or any other reduction in insurance rates, with no relief for insurers, by relegating insurers to retroactive review where constitutional standards will not apply. State legislatures considering insurance reform, and state insurance commissioners promulgating regulations, surely will heed the lesson.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for writ of certiorari and set the case for plenary review.

February 5, 1996

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